# DOW THEORY LETTERS INC.

RICHARD RUSSELL
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THE MARKET: Over the past year this nation has been subject to an almost unprecedented barrage of inflation. In fact, inflation itself has been espoused as the primary reason for the mass public movement into common stocks, a rush which has no parallel in American history (see accompanying news clip). Everyone and his brother now knows about inflation, but I am reminded of the old Wall Street adage which says that what everyone knows no longer has an influence on stock prices.

It is interesting to note that the D-J Industrial Average on January 1, 1968, closed at 906.85. This means that there has been a net loss in this famous investment-grade Average so far during the inflationary year 1968. It also suggests that the main body of stocks has been under massive distribution to the public and the funds, distribution in the face of a listless and sluggish performance on the part of the D-J Industrial Average. It should be remembered that the Dow is still almost 100 points below its February, 1966 bull market high of 995.15. This while the Federal Reserve has flooded the nation's money supply, this while the entire price structure of the country has been steadily inflated.

Why the stubborn resistance by the Dow to the tides of inflation? Because another tide has been exerting its superior force, and this is the tidal force of the primary bear market. Under the foam and bubbles of speculation, under the political pronouncements and brave words of our leaders,

## *Main Street storms Wall Street*

**By John Dillin**
*Staff writer of The Christian Science Monitor*

Rapid inflation and dreams of a fast dollar are tempting many Americans to take the plunge into this year's churning stock market.

Sales this spring have smashed record after record as tens of millions of shares change hands almost every day on the exchanges in New York. On the Big Board alone, sales climbed to 21.4 million shares worth $1.1 billion one day this month.

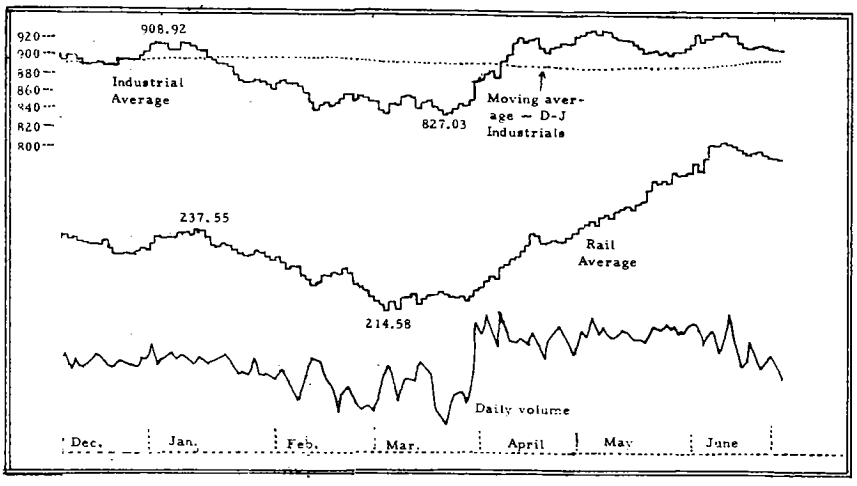
Ordinary people across the country—secretaries and salesmen, professors and physicians—are joining the market rush. But a spot survey by this newspaper of 40 investors across the country indicates their motives are defensive as often as they are speculative.

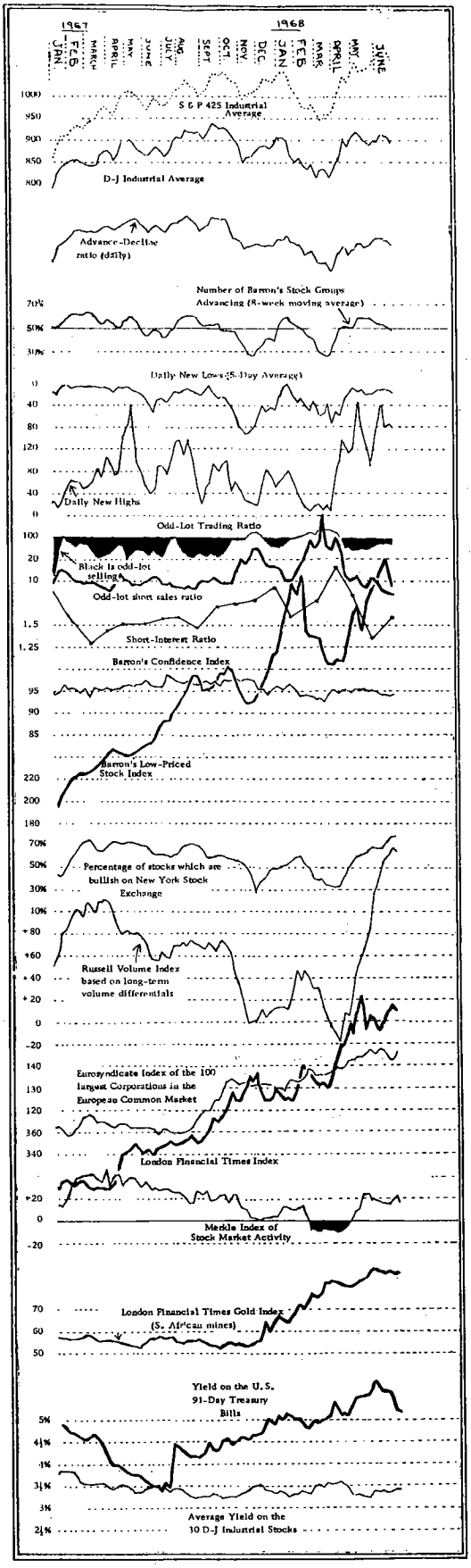
The owner of a real-estate firm on Long Island summed it up for many of them when he said:

"The market generally runs with inflation, and we're due for a big inflation in the next couple of years."

A Boston investor commented:

"The banks pay 5 percent interest, but inflation is running nearly that high. The market is one way to try to make your money grow."





1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 10 D-J Industrial Stocks

 under the optimism created by record sales and gross national product, the bear waits his turn. He is invisible now, but in his claws he still holds the big investment stocks as represented by the D-J Averages. The bear has absorbed all the inflation talk, the juicy profits forecasts, the record volume, the hopes of the public— and still he will not let the Averages go to new highs.

What happens when the economic picture changes? What happens when Wall Street, the funds and the public become disillusioned with the inept way our Government is handling its fiscal affairs, when the tax bite starts showing up in corporate and individual earnings, and when the economy cools off in general? What happens when the gathering forces of deflation slowly overcome, then smother the inflationary pressures? This is what the bear is waiting for, and when that comes to pass he will emerge and run rampant.

The very knowledgeable Alden Wells, in his latest (July) Monetary Report believes that the stage is set for things to come. "If we are to have the worst of all possible worlds, four conditions must be met. First, nobody pays attention to a commodity market that rose rapidly but then declined; second, nobody pays attention to a bond market that declined then rose; third, a monetary crisis that confuses everyone so much that they refuse to understand; and fourth, unparalleled stock speculation. Now all four conditions have been met."

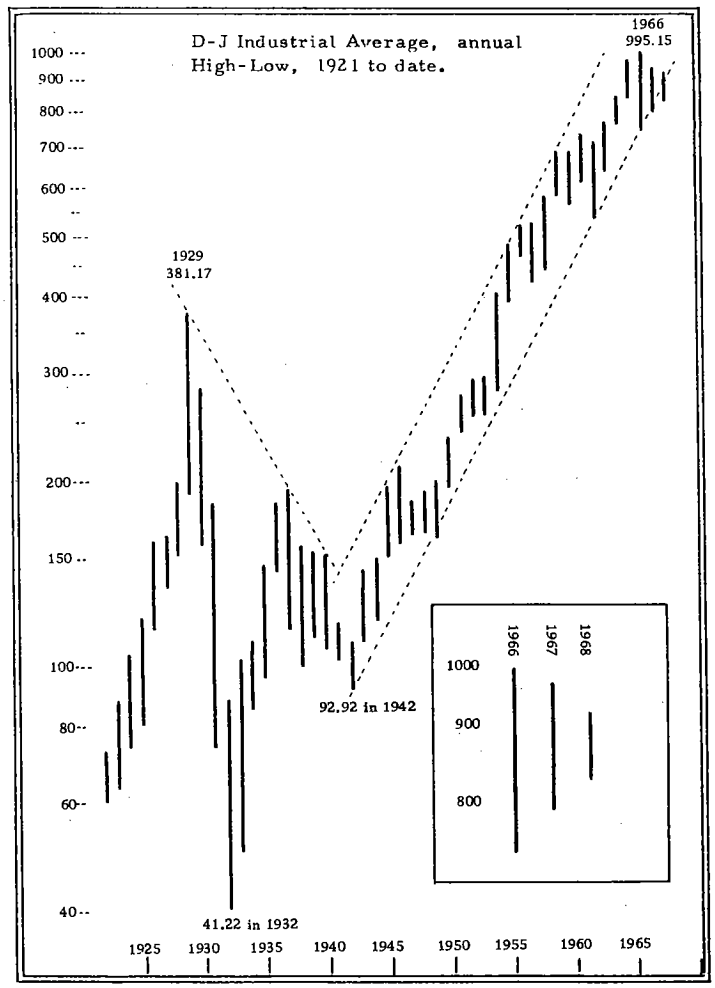
Wells then notes that the market is at the point where it must search avidly for more suckers (and I agree with this thesis). After all, in order to support absurd price/earning ratios on absurd stocks, a new army of suckers must be mustered almost weekly. Speculative stocks are bought to be run up and then sold to the guy next door. But the guy next door already has a full garbage pail, and this is what is going to cause trouble in the period ahead. The old Wall Street hauling service can just hold so much at any one time, but when everyone wants to unload on the truck simultaneously we have chaos.

Meanwhile, on the N.Y.S.E. volume has subsided a bit as the Dow Industrials hover in the 890-910 area. As seen on the page 1 chart, the 890 area would seem to be particularly significant with traders probably remaining hopeful as long as the Dow manages to close above that level. Any break below 890 could complete a potential April to July top, a top which has assumed the form of a "head-and-shoulder" in the Dow.

Five points below 890, at 885 we find the 200-day moving average of the Dow. So far in this primary bear market the Dow has plunged below its own 200-day moving average on three occasions. The first was in May, 1966, prior to a severe downward descent to 744.32. The second penetration came in October, 1967, and this move took the Dow to 849.57 in October, 1967. The third penetration occurred in January, 1968, a move that terminated in March, 1968 at 825.67.

I believe that any decisive penetration below the current moving average level of 885 could be the prelude to a drop of perhaps greater extent than anything yet seen in this bear market. Remember, the bear has been held in abeyance for over two years now, and I would consider another breaking of the moving average as a signal that the bear is coming out into full view again.

Considerable bullish comment has been aroused by the new record 22 million share short position on the N.Y.S.E. However, I am allowing for the upward bias in the short interest plus the fact that a good deal of the shorting represents arbitrage and stock splits. This month, of the 2 million short interest increase, 1.5 million of it was brought on by a switching of stocks from the AMEX to the N.Y.S.E. Interestingly, the Drew Odd-Lot report shows that their graph of the short interest in 13 active N.Y.S.E. leaders has sunk to a new low for the past few years. All in all, I would not attribute too much bullishness to the short interest in this primary bear market.




INSIDE THE INSIDE: The accompanying chart traces the closing high and low for the D-J

Industrials Average from 1922 to date. The chart is interesting from two major standpoints, the first being the long, extended upward channel which has formed since the low closing of 92.92 in 1942.

Actually, the high and low for the Dow have been contained within the upper and lower trendlines of the channel for the past 27 years. This is certainly a record in all stock market history.

As seen on the chart, the 1967 low of 786.41 broke very slightly below the lower trendline, but by late 1967 the Dow was rallying again. Then, in March of 1968 the Dow sank to a low for the year at 825.13. The 1968 low very definitely took the Dow below the channel line, but again since March the Industrial Average has rallied sharply. At 900 the Dow is right on the lower channel line.

I believe that any decisive drop below the 825.13 low of 1968 would be doubly significant, since a further definite penetration of 825.13 would mean that the 27 year upward channel was finally in the process of being reversed. It is well to remember that the longer and more sustained a trend, the longer and more important the reverse trend when it finally materializes.

The second point of major interest on this chart is shown in expanded form in the small box on the lower right. Here we see the high and low for the year 1967 holding within the high and low limits of the preceding year 1966. Now the highly interesting factor is that so far, the year 1968 is another "inside" year, having held within the high and low limits of 1967.

Nowhere in past history as seen on the chart has Wall Street produced three years in a row, each year's range holding within the confines of the preceding year. Therefore, we can say that the odds are overwhelming that 1968 will not end as another inside year. In other words, the odds heavily favor either an advance over the 1967 high of 943.08 or a decline below the 1967 low of 786.41.

VICTORY BUT STILL AT SEA: Here is the way it is supposed to work (see news clip) according to the word from our leaders in Washington. The new 1968 Federal deficit will run to $25 billion or more, but the passage of the tax bill and budget cuts have saved the nation from the worst deficit in its history.

The tax bill will bring in around $13 billion in additional revenue (out of the pockets of American citizens and businesses) and the budget cuts (no one knows what is to be cut yet) will lop off another $6 billion. This drastic surgery will bring our deficit down below $8 billion.

Arthur Okun, Chairman of the President's Economic Advisers, held a news conference on June 24. At that meeting he announced that the tax bill would provide an added special attraction; not only will the nation have an $8 billion deficit instead of a $25 billion deficit, but the tax bill will serve "to cool off" the economy as well. Mr. Okun added, however, that no immediate lessening of inflationary pressures will be seen.

A number of highly respected economists have taken issue with Mr. Okun's optimism. For instance, Jay Levy, an economist with an enviable record of calling the turns, writing for Barron's has already dubbed the new bill "the recession bill of 1968." Levy notes that high interest rates have already hurt private and industrial construction. "The adoption of the tax bill," states Levy, "would further impede business expansion so much that the whole economy would suffer regardless of changes in monetary policy." Levy concludes, "If it (the tax bill) is enacted, the economy will become sluggish within weeks. The chances of a recession occurring in the autumn of 1968 will be better than 50-50."

I happen to agree with Mr. Levy. Furthermore, the implications of a recession with accompanying shrinkage in corporate and individual earnings are rather frightening to contemplate at this time. For with shrinkage of earnings and income comes a contraction in Government tax receipts. Any narrowing of tax receipts at this time of monumental spending will quickly produce a new set of deficits the likes of which this nation dare not even contemplate. As far as I am concerned, the 1968 tax bill is going to be a case of "out of the frying pan and into the fire."

# 1968 Deficit Now Estimated At $25 Billion

*Editorial — Page b-2*

**Copley News Service**

WASHINGTON — President Johnson's top monetary advisers yesterday reported the fiscal 1968 budget deficit will soar to about $25 billion — up from an original forecast of $19.8 billion.

They said they now hoped, with the aid of the new 10 per cent surcharge on income taxes, to hold the fiscal 1969 deficit below the $8 billion predicted in January.

President Johnson met yesterday with Arthur Okun, chairman of his council of economic advisers; Henry Fowler, secretary of the treasury; William McChesney Martin, chairman of the Federal Reserve Board, and Budget Director Charles Zwick.

**FUNDS DISCUSSED**

Okun told newsmen the discussion included monetary issues, particularly the new tax increase coupled with a mandatory $6 billion cut in spending.

"All agreed the economy will receive the decisive cooling off it needs," he said.

Okun said delay in approving the tax increase boosted the

 Another adverse aspect of the tax bill will be renewed inflationary pressures as businessmen boost prices in an attempt to hold profit margins. With higher taxes and higher costs for labor, the squeeze will be on, and the only plus factor that can be hoped for is a rise in volume of sales. If Mr. Levy is correct, if a recession could enter the picture before 1969, we will have the most drastic combination of profit-destroyers of all, higher taxes, higher costs for wages and materials, and lower volume of sales. It is the prospect of lower sales volume in the light of higher costs which frightens every businessman. This is why a recession would be so diastrous if it occurred during 1968 and 1969.

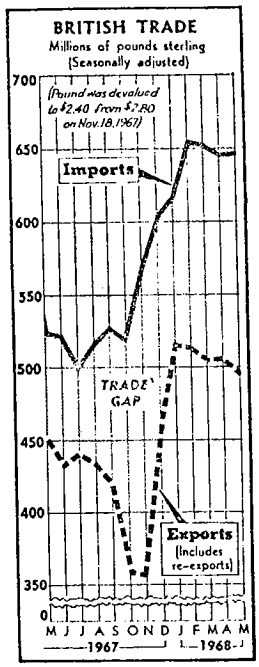
I would guess that a forthcoming recession could reduce many corporate profits almost to the vanishing point. I might also add that if a recession does occur, it would be the first one in a generation to appear within the framework of a true primary bear market in stocks. Therefore, I would expect a business contraction or set off a chain of events in the economy and the stock market which would be more prolonged and drastic than anything the most stony bear now envisions. The picture ahead is set for violent change and high drama. I warn subscribers to expect the unexpected. Remember, this primary bear market has been held "in check" for over two years now. When the bear comes out of his lair again he will in all likelihood make up for lost time.

JUST ANOTHER WEAK CURRENCY: Note the accompanying clip from the lead-off article in the latest London Economist:

The narrow chart shows the British trade gap for May, a whopping "no-improvement" gap of $206 million. This has occurred after the pound was devalued and after all the British attempts at fiscal and economic conservatism. All measures have all failed miserably, as even the most hopeful Britain must now admit. For the British trade deficit is now running at an annualized rate of over $4.5 billion a year, a rate that is totally unsustainable.

In the first quarter of 1968 the balance of monetary movements out of Britain was the worst ever recorded ; in consequence, the country's total balance of payments deficit in the six months to March was running at an annual rate of £1,352 million, compared with the £776 million which the wicked Tories left behind them in 1964. To pile on the gloom, the monthly trade figures for May have shown the same deficit of £86 million as they did in April (which means that, since that horrible first quarter, the average visible trade deficit has actually got £21 million a month worse). It is against this very worrying background that Britain now moves into one of those familiar few weeks of June and July madness during which it seems to be generally expected that labour troubles should cripple the motor industry, the railways, the airways, the steel industry, and heaven knows what else.

The result is that the pound is about finished as a reserve currency (a currency that can be held by assorted Central Bankers as a reserve that is "as good as gold"). The fact is that those who now hold pounds are holding them with their fingers crossed. If they could get out of all pounds they would. Pound holders are slowly easing out of the British currency—into gold, dollars, Swiss Francs, German marks.




Britain itself has now made it known that it wants to drop the pound as a reserve currency. The British Government is trying to arrange a new international loan in order to pay off governments that bank pounds, thereby allowing those governments to switch into dollars or gold.

This would, of course, mean that the dollar would stand alone as the Free World's only reserve currency. Gold, itself, would be the other real reserve. The danger here is that far too many governments already have more dollars than they want. If they pile up new dollar reserves they would be tempted to turn these in for U.S. gold in the event of any further doubts regarding the status of the dollar.

The move out of pounds is now considered irreversible, whether Britain receives its international loan or not. In fact, the trend out of pounds has been going on for a long time. During the 1920's almost all international transactions were cleared in pounds. The latest estimate is that currently about 25% of world trade is in pounds and this figure is being reduced almost monthly.

With the current trend towards eliminating the pound as a reserve currency, with the drastic 1967-68 weakness in the pound and the recent 14.3% devaluation, with a current new round of British labor troubles, I would expect important trouble for British currency before 1968 is out. It appears to be a race to eliminate the pound as a reserve currency on an official basis—before the pound is simply eliminated from Central Banks through panic and fear.

The pressure is now on, and it is a question of whether the various nations will support the pound in some sort of orderly way prior to its exit as a reserve currency or whether the whole matter will explode in an uncontrolled stampede out of sterling—into dollars and gold.

I would guess that the coming move out of pounds and into gold ( and dollars) will prove a very large plus for gold in the period ahead. For if the pound goes, suspicion will immediately increase regarding the status of the dollar. When paper currencies the world over (particularly reserve currencies) are under suspicion, men automatically turn to the only monetary vehicle which has passed the test of value over the centuries—gold.

THE AVERAGES: Last week I received a letter from investment service owner Harry Schultz in which he urged me to take up a defense of the D-J Average. "Have you noticed how many people have been attacking the D-J Averages lately?" writes Harry. He continues, "I hope you noticed my defense of the D-J Averages in my report 162. _____ _____ is dropping the D-J's from his service entirely, and _____ _____ has been damning them each week and telling us that only his average is worth anything. I strongly urge you to take up the defense also."

The fact is that I have been defending the D-J Averages for over a decade. In the late 1950's most of my defense had to do with the Rail Average alone. Dozens of letters implored me to drop the Rails, substitute Trucks or Airlines. The Rails, I was warned, represented a dying business and the sooner I discarded the implications of the Rail Average, the better. Of course, the fact was that the Rails were not doing what people wanted them to do. They were not rising above their old 1929 highs, and therefore (since people wanted to be bullish) I was urged to see the handwriting on the wall and eliminate the carriers as a part of Dow's Theory.

Currently, the D-J Industrial Average is not doing what people want it to do. Being made up of 30 of the largest corporations in the nation (representing 25% of the total value of the N.Y.S.E.), these 30 stocks are not apt to reflect fully the impact of the recent frenzied speculation. I might add that in those periods when the Dow leads the rest of the market to higher ground, complaints about the senior Average dribble off to practically nothing.

There is nothing new about the complaints or the defenses. Thirty-three years ago the great Dow Theorist, Robert Rhea, was defending the D-J Averages. Here are a few words from Rhea's May 4, 1935 report: "The Annalist (the old New York Times financial section) recently suggested that the popular newspaper stock averages are misleading. Other publications, apparently seeking for something to fill space, have added their own views on the subject. There is nothing new in all this. Every year or two somebody starts such an argument.

"Since 1897 the D-J Averages have been the world's most dependable yardstick of American stock values. Since 1897 literally hundreds of newspapers or advisory services have inaugurated the compilation of independent averages, but few of these have continued over any considerable length of time. Various compilators have injected all sorts of fancy mathematical formulae into their compositions. There have been averages based on the square or the cube roots of individual prices. Others attempt to relate price and volume, while some believe that the figures should be arbitrarily weighted by this or that. These fads and fancies come and go; meanwhile, the D-J Averages continue to be the accepted standard. The D-J figures are calculated hourly, and are placed on news tickers and brokers wires minutes later, so these figures are 'hot'. Their's is a simple arithmetical average which can be readily understood or calculated by any student of the market. The factors used are published daily in the Wall Street Journal together with a list of stocks used in their compilation."

It should be remembered that the D-J Industrial Average was never meant to be a speculative barometer or a measure of all the activity on the N.Y.S.E. The index is a gauge of the backbone of America, thirty corporate giants whose good fortunes or tribulations reflect to a large extent the trends of this nation's business.

NOTES & QUOTES: From Elliot Janeway's May 20 newspaper column: "The Russians and the French have a common interest in pushing up the price of gold at the expense of the dollar. The Russians produce it for export, and the more they get for it the better they do against their customers. The French have loaded up on it in anticipation of forcing America to buy it back at much higher prices. The dollar was under pressure before LBJ subjected it to the new threat of a Russian veto of the peace talks unless we gave in on gold. In Paris, deGaulle is ready to intervene against the dollar when the critical moment arrives for Russia to demand a higher price for gold, as her condition for letting the peace talks go on." (my note, I thought that last sentence was fascinating and certainly presents a bombshell of an idea).

Meanwhile, France has sold a quantity of gold due to pressure from her domestic crisis. The whole French crisis has occasioned much glee on the part of the U.S. press, but I feel the happiness is misplaced. If the franc goes under (is forced to devalue), it will doubtless set off a chain of devaluations which will soon place new mounting pressure on our over-valued dollar. Many analysts have the erronious idea that a French franc in trouble will somehow help the dollar. Nothing could be further from the truth.

* * * *

Here are some little known facts compiled by the Bank for International Settlements. The half year now ending is the first time that American corporations have had the benefit of the 1964 cut in the tax cut from the Korean war level of 52% to the lower 48% figure. But in the coming half year the retroactive new rate of 52.8% (due to the new tax bill) coupled with the new speed-up will push the tax rate for large corporations with constant income from 48% to 63.4%. As Reuters Financial Editor Sydney Gambell put it last week, "This half-year's drop in the corporation tax take.....to 48% has produced much inflationary euphoria which might not outlast an imminent jump to 63.4%."

# DOW THEORY MARKET LABORATORY PAGE

ELLIOT WAVE: I have for many years followed leading proponents of the Elliot Wave Principle. This is a relatively simple theory based on R.N. Elliot's studies during the 1930's of "nature's law" of movements as applied to the market. The "simplicity" of the theory, upon careful study, becomes extremely complicated with many ramifications and nuances, so many that they could not begin to be taken up here. Suffice it to say that Elliot concluded that major (primary movements) take place in a series of five's (three movements with the trend, two against). Corrective movements occur in three's (two with the trend and one against the trend).

I had correspondence with Hamilton Bolton regarding the Wave theory prior to that brilliant man's death a few years ago. I also had some correspondence with one of Elliot's most brilliant successors, A.J. Frost.

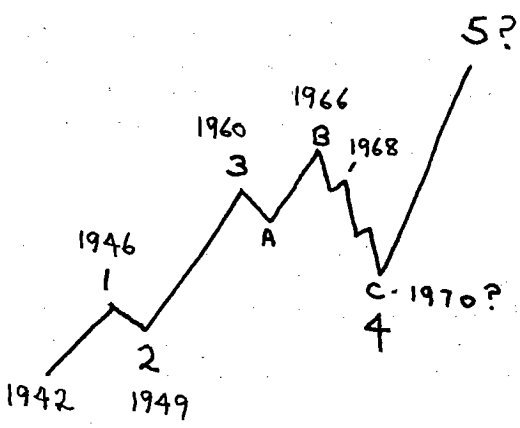
Bolton believed that a major upward cycle ended in 1966 at 995.15 (closing) on the Dow. He then expected a full downward correction (bear market) from the 1966 high to some future low point perhaps in the 550 to 700 area. Bolton felt that the 1966 decline represented wave A, that an upward corrective wave B would follow (B is perhaps just now being completed). Then a final downward C wave would complete the bear market. The final C wave (which could now be beginning) would take the form of a five-wave, three downward waves and two correcting upward waves. This final C wave should be of greater extent than the first A downward wave (i.e., greater than the 1966 decline).

A.J. Frost differed with Bolton in interpretation. Frost believed that the great bull market started in 1942 (Bolton thought 1949). Frost believed the first bull wave ended in 1946 at 212, then a corrective wave took the Dow back to the 1949 low of 161. Wave 3 then carried to the 1960 Dow high of 685. From the 1960 high, Frost believed that a complicated, "consolidation" wave (wave 4) was in progress. The A part of Frost's wave 4 took the Dow from the 1960 high of 685 to the 1962 low of 535. The B part of this irregular correction took the Dow to the 1966 high of 995.15. From the 1966 high, Frost expected a final C wave down, a C wave broken into five parts which might take the Dow back to the neighborhood of the 1962 low (i.e., the mid-500's on the Dow). Following this completion of corrective wave 4, Frost expected a final great 5th leg up, and this fifth leg or wave would complete the bull market.

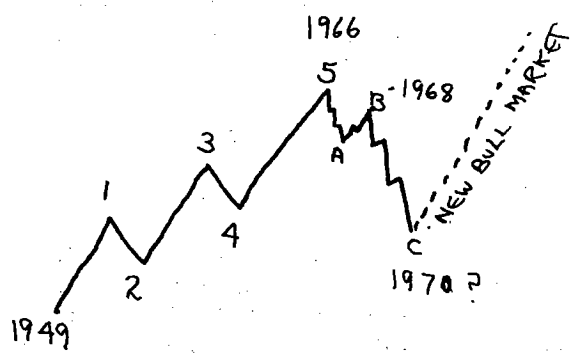
The difference between Bolton's and Frost's interpretation is that Bolton expected the next C wave down to complete the bear market (Bolton felt that the bull market ended in 1966), and that following the next major wave down from here a new super-cycle bull market would begin.

From the practical standpoint, both Frost and Bolton are now pointing to danger in that both would expect that we are now seeing an important corrective wave. Frost would say that we are about to see the end of corrective wave 4, leading to the final upward bull wave 5 (completing the whole bull market which started in 1942). Bolton would say that we are about to see the final part of the bear market which started in 1966, and that following this we will begin a totally new bull market.

With many thanks to the extraordinary analyses provided by the Bolton-Tremblay Bank Credit Analyst.



Frost's interpretation



Bolton's Interpretation